

ARTICLES

THE CONCEPT OF 'ABUSE OF LAW' IN THE CASE LAW OF THE EUROPEAN COURT OF JUSTICE ON DIRECT TAXATION

KOEN LENAERTS*

ABSTRACT

Time and again, the Court of Justice has made clear that EU law does not protect natural or legal persons who seek to pay less tax by creating situations that artificially fall within the scope of application of the fundamental freedoms. In the light of the judgments of the Court of Justice in Cadbury Schweppes, Thin Cap and Glaxo Wellcome, this contribution describes the steps that a national court must follow when determining whether a particular behaviour constitutes an abuse of law in the field of direct taxation.

Keywords: abuse of law; Court of Justice; direct taxation; fundamental freedoms; wholly artificial arrangements

§1. INTRODUCTION

In the field of direct taxation, it is of paramount constitutional importance to draw a conceptual distinction between 'tax mitigation' (or 'tax avoidance') and 'tax evasion', since that distinction is essential for the Court of Justice in determining the extent to which EU law places limits on the exercise of national taxing powers. On the one hand, the expression 'tax mitigation' relates to situations where an individual (or a company) seeks, in compliance with the law, to minimize the taxes he or she (or it) pays. In a cross-border context, tax mitigation is made possible by regulatory competition among the national tax systems. Given that the power to levy direct taxes remains with the Member States, the latter are, for example, free to 'organise, in compliance with [EU] law, [their] system for taxing distributed profits and, in that context, to define the tax

* Vice-President of the Court of Justice of the European Union, and Professor of European Union Law, Leuven University. All opinions expressed herein are personal to the author.

base and the tax rate which apply to the shareholder receiving them'.¹ As Member States apply different income and corporation tax rates, a natural (or legal) person may decide to exercise an economic activity in a Member State other than his or her (or its) state of residence so as to profit from tax advantages. '[An EU] national', the Court of Justice stated in *Barbier*, 'cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence'.² Consequently, the application of the fundamental freedoms cannot be ruled out by the fact that the exercise of such freedoms is motivated by a desire to mitigate tax liabilities.

On the other hand, an EU national may not rely on the fundamental freedoms in a way that undermines the effectiveness of the tax system of the Member State that has jurisdiction to tax him or her. In the Court of Justice's words, 'nationals of a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation. They must not improperly or fraudulently take advantage of provisions of [EU] law'.³ Accordingly, EU law does not protect natural or legal persons who seek to pay less tax by creating situations that *artificially* fall within the scope of application of the fundamental freedoms. Restrictions on the free movement of companies and capital which seek to prevent tax evasion and do not go beyond what is necessary to attain that objective are compatible with EU law. In summary, whilst a Member State may not prevent genuine tax mitigation, EU law does not provide a shield for tax evaders.

Logically, the question is then how to draw a distinction between those two concepts. To that end, the Court of Justice has developed the concept of 'abuse of law',⁴ according to which 'a national measure restricting [a fundamental freedom] may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned'.⁵ This means that a Member State may adopt measures which, whilst constituting a restriction on free movement, seek to prevent abusive practices and are thus able to be justified.

¹ See, e.g., Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, EU:C:2006:773, para. 50; Case C-446/04 *Test Claimants in the FII Group Litigation*, EU:C:2006:774, para. 47; Case C-194/06 *Orange European Smallcap Fund*, EU:C:2008:289, para. 30; Case C-128/08 *Damseaux*, EU:C:2009:471, para. 25; Case C-284/09 *Commission v. Germany*, EU:C:2011:670, para. 45; and Case C-387/11 *Commission v. Belgium*, EU:C:2012:670, para. 37.

² Case C-364/01 *Barbier*, EU:C:2003:665, para. 71.

³ Case 115/78 *Knoors*, EU:C:1979:31, para. 25; Case C-61/89 *Bouchoucha*, EU:C:1990:343, para. 14; and Case C-212/97 *Centros*, EU:C:1999:126, para. 24.

⁴ See, generally, R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?* (Hart Publishing, 2011); and A. Saydé, 'Defining the Concept of Abuse of Union Law', 33 *Yearbook of European Law* (2014), p. 138–162.

⁵ See, to that effect Case C-264/96 *ICI*, EU:C:1998:370, para. 26; Case C-324/00 *Lankhorst-Hohorst*, EU:C:2002:749, para. 37; C-9/02 *Lasteyrie du Saillant*, EU:C:2004:138, para. 50; and Case C-446/03 *Marks & Spencer*, EU:C:2005:763, para. 57.

The purpose of my contribution is thus to explore the concept of 'abuse of law' as applied by the Court of Justice in the field of direct taxation. To that effect, it is divided into three sections. Section 2 provides a very brief account of the evolution of the concept of 'abuse of law' in light of the case law of the Court of Justice, from its first appearance in *Van Binsbergen* to its application in *Halifax*. Section 3 is devoted to examining *Cadbury Schweppes*,⁶ the landmark case in which the Court of Justice explained, for the first time, the role played by the concept of abuse of law in the field of direct taxation. Section 4 looks at two important direct taxation cases decided in the aftermath of *Cadbury Schweppes*, namely *Thin Cap*⁷ and *Glaxo Wellcome*.⁸ Finally, a brief conclusion describes the steps that a national court must follow when determining whether a particular behaviour constitutes such an abuse (Section 5).

§2. HISTORICAL EVOLUTION

At first, the Court of Justice did not provide a definition of abusive practices, but limited itself to acknowledging that Member States were, in principle, entitled to counter so-called 'U-turn' or 'circumvention' transactions, that is

situations where either persons or goods move from one Member State to another, although the final destination of the transaction is the original Member State; the central focus is the exercise of a right conferred by [EU] law, the right to free movement, in order to circumvent the national law of a Member State.⁹

In the key passage of *Van Binsbergen*, the first case to which the doctrine of abuse can be traced, the Court of Justice ruled that

a Member State cannot be denied the right to take measures to prevent the exercise by a person providing services whose activity is entirely or principally directed towards its territory of the freedom guaranteed by article [56 TFEU] for the purpose of avoiding the professional rules of conduct which would be applicable to him if he were established within that state.¹⁰

However, as the Court of Justice made clear in *Kefalas* and *Centros*,¹¹ the *Van Binsbergen* line of case law¹² did not imply that Member States enjoy a '*carte blanche*' in the application

⁶ Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas*, EU:C:2006:544.

⁷ Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, EU:C:2007:161.

⁸ Case C-182/08 *Glaxo Wellcome*, EU:C:2009:559.

⁹ See R. De La FERIA, 'Prohibition of abuse of (Community) law: The creation of a new general principle of EC law through tax', 45 *Common Market Law Review* (2008), p. 395–441, 399.

¹⁰ Case C-33/74 *Van Binsbergen v. Bedrijfsvereniging voor de Metaalnijverheid*, EU:C:1974:131, para. 27.

¹¹ Case C-367/96 *Kefalas*, EU:C:1998:222; and Case C-212/97 *Centros*.

¹² See, regarding the freedom to supply services, Case C-148/91 *Veronica Omroep Organisatie v. Commissariaat voor de Media*, EU:C:1993:45, para. 12; and Case C-23/93 *TV 10 v. Commissariaat*

of [their] own national anti-abuse provisions'.¹³ The Court of Justice declined to hold that national measures prohibiting 'U-turn' or 'circumvention' transactions fall outside the scope of application of the fundamental freedoms. In so far as those measures constitute a restriction on free movement, the fact that they seek to combat abusive practices must therefore be examined in terms of a possible justification for such a restriction. As the Court of Justice pointed out in *Kefalas*,

the application of [a national rule, which provides that "the exercise of a right is prohibited where it manifestly exceeds the bounds of good faith, morality or the economic or social purpose of that right",] must not prejudice the full effect and uniform application of [EU] law in the Member States (...). In particular, it is not open to national courts, when assessing the exercise of a right arising from a provision of [EU] law, to alter the scope of that provision or to compromise the objectives pursued by it.¹⁴

In the same way, in *Centros*, the Court of Justice ruled that the exercise of the right to free movement could not give rise to abuse in itself. For the Court of Justice,

the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment.

'The right to form a company in accordance with the law of a Member State and to set up branches in other Member States', the Court of Justice also wrote, 'is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty'.¹⁵ Thus, *Van Binsbergen*, *Kefalas* and *Centros* all point to the need for a method of analysis capable of distinguishing situations involving the legitimate exercise of a fundamental freedom from those that give rise to abusive practices.

In *Emsland-Stärke*,¹⁶ the Court of Justice seized the opportunity to develop a test that would allow national courts to draw a distinction between those two types of situations. The facts of the case were as follows. *Emsland-Stärke GmbH*, a German company, exported several consignments of a potato-based product to Switzerland, for which it

voor de Media, EU:C:1994:362, para. 21; regarding the freedom of establishment, Case 115/78 *Knoors*, para. 25; and Case C-61/89 *Bouchoucha*, para. 14; regarding the free movement of goods, Case 229/83 *Leclerc and Others v. Au Blé Vert and Others*, EU:C:1985:1, para. 27; regarding social security, Case C-206/94 *Brennet v. Paletta*, EU:C:1996:182; regarding the free movement of workers, Case 39/86 *Lair v. Universität Hannover*, EU:C:1988:322, para. 43; regarding the common agricultural policy, Case C-8/92 *General Milk Products v. Hauptzollamt Hamburg-Jonas*, EU:C:1993:82, para. 21; and regarding company law, Case C-367/96 *Kefalas*, para. 20.

¹³ D. Weber, 'Abuse of Law – European Court of Justice, 14 December 2000, Case C-110/99, *Emsland-Stärke*', 31 *Legal Issues of Economic Integration* (2004), p. 43–55, 50.

¹⁴ Case C-367/96 *Kefalas*, para. 21 and 22.

¹⁵ Case C-212/97 *Centros*, para. 27.

¹⁶ Case C-110/99 *Emsland-Stärke*, EU:C:2000:695.

received an export refund. Subsequently, inquiries conducted by the German customs authorities revealed that immediately after their release for home use in Switzerland, the exported consignments in question were transported – unaltered and by the same means of transport – to Italy or back to Germany. Hence, those authorities demanded that Emsland-Stärke GmbH repay the export refund. Taking the view that it had met the conditions for the grant of export refunds set out in Regulation No 2730/79,¹⁷ Emsland-Stärke GmbH challenged that decision. Thus, the crux of the case was whether, in the event of a purely formal dispatch from the EU territory with the sole purpose of benefiting from an export refund, Regulation No 2730/79 precluded an obligation to repay that refund. The Court of Justice replied in the negative: 'the scope of [EU] regulations must in no case be extended to cover abuses on the part of a trader'.¹⁸ Next, the Court of Justice went on to explain what is to be understood by 'abuse'. The key passages of the judgment merit quotation in full.

A finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the [EU] rules, the purpose of those rules has not been achieved.

It requires, second, a subjective element consisting in the intention to obtain an advantage from the [EU] rules by creating artificially the conditions laid down for obtaining it. The existence of that subjective element can be established, *inter alia*, by evidence of collusion between the [EU] exporter receiving the refunds and the importer of the goods in the non-member country.¹⁹

It was for the national court to establish whether the actions of Emsland-Stärke GmbH contained both objective and subjective elements that would lead to a finding of abuse. *Emsland-Stärke* is thus a seminal judgment which laid down, for the first time, 'the criteria for determining the existence of abuse for the purposes of EU law'.²⁰ However, that judgment left open one important question, namely whether that definition of abuse was limited to the field of agricultural levies or whether it could be extrapolated to other areas of the EU legal order, notably to the field of taxation.

In *Halifax*,²¹ a case concerning the interpretation of the Sixth VAT Directive,²² the Court of Justice replied in the affirmative to the latter part of that question. In that case,

¹⁷ Commission Regulation (EEC) No 2730/79 of 29 November 1979 laying down common detailed rules for the application of the system of export refunds on agricultural products, [1979] OJ L 317/1 (repealed).

¹⁸ Case C-110/99 *Emsland-Stärke*, para. 51.

¹⁹ *Ibid.*, para. 52 and 53.

²⁰ R. De la Feria, 45 *CML Rev* (2008), p. 410. See also D. Weber, 31 *LIEI* (2004), p. 51.

²¹ Case C-255/02 *Halifax and Others*, EU:C:2006:121.

²² Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, [1977] OJ L 145/1.

Halifax, a banking company, wished to build new call centres in Northern Ireland. Since most of its services were exempt from VAT, it was only able to recover a small portion of the input tax for which it was liable, namely 5% of the VAT paid for construction works. However, following the tax planning scheme elaborated by its advisers, Halifax decided to set up a series of transactions involving different companies of the Halifax group which, in principle, enabled it to recover all of the input VAT paid in respect of those construction works. It applied for repayment of the input VAT paid for those works, but the UK tax authorities rejected its application on the ground that a transaction entered into solely for the purpose of VAT avoidance was neither itself a 'supply', nor a step taken in the course or furtherance of an 'economic activity' within the meaning of the Sixth Directive. Accordingly, the referring court asked the Court of Justice whether transactions of the kind at issue in the case at hand indeed constituted 'supplies of goods or services' and 'economic activity' within the meaning of the Sixth VAT Directive where the sole purpose of those transactions was to obtain a tax advantage. In that regard, the Court of Justice pointed out that the purpose pursued by those transactions was irrelevant, in so far as they satisfied the objective criteria on which the concepts of 'supplies of goods or services' and 'economic activity' are based.

In addition, the UK tax authorities argued that, in light of the general principle of EU law preventing 'abuse of rights', those transactions should be disregarded and the terms of the Sixth VAT Directive applied to the true nature of the transactions at issue. The referring court thus asked the Court of Justice whether the right to deduct input VAT was ruled out where the transactions on which that right was based constituted an abusive practice. The Court of Justice began by recalling the key passage in *Emsland-Stärke*, according to which '[t]he application of [EU] legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by [EU] law'.²³ Hence, the Court of Justice made clear that '[the] principle of prohibiting abusive practices [as defined by the case law] also applies to the sphere of VAT'.²⁴ This did not mean, however, that the Sixth VAT Directive opposed tax planning. '[T]axpayers', the Court of Justice stressed, 'may choose to structure their business so as to limit their tax liability'.²⁵ Just as it did in *Emsland-Stärke*, the Court of Justice was thus obliged to provide the national court with a method of analysis capable of distinguishing between legitimate and abusive VAT transactions. To that effect, it noted that an abusive practice takes place where:

(...) first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation

²³ Case C-255/02 *Halifax and Others*, para. 69.

²⁴ *Ibid.*, para. 70.

²⁵ *Ibid.*, para. 73.

transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.

Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.²⁶

It was for the national court to make those determinations. With regard to the first element, the national court had to take into account the principles underpinning the VAT system, in particular the complete neutrality of taxation of all economic activities and the existence of a direct and immediate link between a particular input transaction and a particular output transaction. Accordingly,

[t]o allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.²⁷

As to the second element, the national court had to 'determine the real substance and significance of the transactions concerned. In so doing, it may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden'.²⁸ If those two conditions were met, those transactions constituted an abusive practice and, as such, '[had to] be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice'.²⁹

It is worth noting that, unlike *Emsland-Stärke*, *Halifax* contains no explicit reference to the 'subjective element' of abuse.³⁰ That silence may be explained by the criticisms put forward by some scholars and Advocates General before the Court of Justice delivered its judgment in *Halifax*.³¹ In particular, in his Opinion in *Halifax*, Advocate General Poiares Maduro argued that the subjective intention of those claiming the EU right in question is not 'decisive for the assessment of abuse. It is instead the activity itself, objectively considered'.³² Indeed, for the Advocate General, 'the intentions of the parties to (...) obtain [improperly] an advantage from [EU] law are merely inferable from the artificial character of the situation to be assessed in the light of a set of objective circumstances'.³³

²⁶ Ibid., para. 74 and 75.

²⁷ Ibid., para. 80.

²⁸ Ibid., para. 81.

²⁹ Ibid., para. 94.

³⁰ R. De la Feria, 45 *CML Rev* (2008), p. 423.

³¹ For an overview of those criticisms, see D. Weber, 31 *LIEI* (2004), p. 53 et seq.

³² Opinion of Advocate General Poiares Maduro in Case C-255/02 *Halifax and Others*, EU:C:2005:200, para. 70.

³³ Ibid., para. 71.

Arguably, a possible reading of *Halifax* suggests that the existence of objective factors may suffice to demonstrate that a transaction involves an abusive practice.³⁴

§3. CADBURY SCHWEPPEES

The logical question that arose following *Halifax* was whether the concept of abuse of law could be applied to cases involving *direct* taxation. Unlike VAT, direct taxation is not harmonized at EU level. Arguably, one could support the contention that an autonomous EU concept of abuse of law, developed by the Court of Justice, may only be applied in those areas in which the EU legislator has exercised its competences. The argument then runs that in the absence of such harmonization, the definition of that concept should be left to national law.³⁵ In *Cadbury Schweppes*, the Court of Justice was confronted with that very question.

It is true that *Cadbury Schweppes* was not the first direct taxation case in which the Court of Justice had to examine the compatibility with EU law of national measures prohibiting ‘circumvention’ transactions. Previously, the Court of Justice had already ruled that Member States could pass legislation ‘specifically target[ing] wholly artificial arrangements’.³⁶ However, the Court of Justice had seen no need to lay down criteria identifying those arrangements, given that the national measures at issue had such a broad scope of application that it was clear that they were not ‘specifically designed’ to counter them.³⁷ *Cadbury Schweppes* offered a good opportunity for the Court of Justice to explain what the expression ‘wholly artificial arrangements’ actually meant.

In that case, the Court of Justice had to determine whether a national court could have recourse to the concept of abuse of law as developed in the case law with a view to examining the compatibility with the freedom of establishment of UK corporation tax law. The legal background of the case was as follows. In the UK, a UK resident parent company was not, as a general rule, taxed on the profits made by a subsidiary as they arose, where that subsidiary was established abroad. However, the UK legislation on controlled foreign companies (‘CFCs’, that is, foreign companies in which the resident parent company owns a holding of more than 50%) established an exception to that general rule: the profits made by a CFC are attributed to the UK parent company and

³⁴ P. Pistone, ‘Abuse of Law in the Context of Indirect Taxation: From (before) *Emsland-Stärke* 1 to *Halifax* (and Beyond)’, in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*, p. 387 (who argues that *Halifax* confirms that ‘the existence of objective factors [is] sufficient for detecting the existence of abusive practices’).

³⁵ R. De la Feria, 45 *CML Rev* (2008), p. 425.

³⁶ See, e.g., Case C-264/96 *ICI*, para. 26.

³⁷ See more recently, Case C-330/07 *Jobra*, EU:C:2008:685. See also R. De la Feria, 45 *CML Rev* (2008), p. 424 and 425; and M. Lang, ‘*Cadbury Schweppes*’ Line of Case Law from the Member State’s Perspective’, in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*, p. 436.

included in the parent company's tax base, although they had not been received by that company, where the CFC was subject to a 'lower level of taxation' in the Member State in which it was established.³⁸ However, the taxation provided for by the legislation on CFCs did not apply where the CFC adopted an 'acceptable distribution policy',³⁹ was engaged in 'exempt activities', satisfied the 'public quotation condition',⁴⁰ or fell below the *de minimis* threshold laid down therein.⁴¹

In addition, that taxation was also excluded where the CFC concerned met the 'motive test' which laid down two cumulative conditions. First, in relation to transactions between the CFC and the parent company which produced a reduction in UK taxation and that exceeded a minimum amount, the taxpayer had to show that the reduction in UK tax was not the main purpose, or one of the main purposes, of those transactions. Second, concerning the reasons for the establishment of the CFC, the taxpayer had to show that achieving a reduction in UK tax by means of the diversion of profits was not the main reason, or one of the main reasons, for the subsidiary's existence in that accounting period.

As to the facts of the case, Cadbury Schweppes (CS), the UK resident parent company of the Cadbury Schweppes group, owned – indirectly through a chain of subsidiaries belonging to that group at the head of which was Cadbury Schweppes Overseas (CSO) – two subsidiaries in Ireland, namely Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI). The business of the latter was to raise finance and to provide that finance to other subsidiaries in the Cadbury Schweppes group. CSTS and CSTI were established in Ireland in order that the profits related to the internal financing activities of the Cadbury Schweppes group could benefit from the tax regime of the International Financial Services Centre in Dublin (the IFSC), according to which companies established therein were subject to a tax rate of 10%. Taking the view that CSTS and CSTI were subject to 'a lower level of taxation', the UK tax authorities decided that, in accordance with the legislation on CFCs, the profits made by CSTI for the 1996 financial year had to be attributed to CSO.⁴² Those authorities thus claimed back corporation tax from CSO in the sum of £ 8 million. CS and CSO challenged that decision on the ground that the taxation provided for by the legislation on CFCs was contrary to the freedom of establishment, the freedom to provide services and the free movement of capital.

³⁸ A 'lower level of taxation' took place where 'the tax paid by the CFC [was] less than three quarters of the amount of tax which would have been paid in the [UK] on the taxable profits as they would have been calculated for the purposes of taxation in that Member State'. Ibid., para. 7.

³⁹ At the material time (1996), this meant that 90% of the CFC's profits had to be distributed within 18 months of their arising and taxed in the hands of the UK resident company.

⁴⁰ This meant that 35% of the voting rights were held by the public, the subsidiary was quoted and its securities were traded in on a recognized stock exchange.

⁴¹ The CFC's chargeable profits did not exceed £ 50,000.

⁴² As CSTS made a loss in that year, no profits could be attributed to CSO.

At the outset, the Court of Justice examined which of those three fundamental freedoms applied to the case at hand. Since the legislation at issue in the main proceedings only applied to foreign companies in which the UK resident parent company owned a holding of more than 50%, ‘giving [the latter company] definite influence on the [foreign companies’] decisions and allowing [it] to determine [their] activities’,⁴³ that legislation came within the substantive scope of the provisions of the Treaty on freedom of establishment. In addition, the Court of Justice held that the fact that companies set up a subsidiary in a Member State other than their state of residence for the purpose of reducing their tax liability does not in itself constitute abuse.⁴⁴ Nor may that fact rule out the application of the freedom of establishment. Next, the Court of Justice held that the UK legislation on CFCs constituted a restriction on the freedom of establishment. It observed that, whilst the profits made by subsidiaries established in the UK were never attributed to their resident parent company, the same did not hold true in relation to subsidiaries established outside that Member State.⁴⁵ Such a difference in treatment entailed a disadvantage for resident companies having subsidiaries outside the UK, thus ‘dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to [a lower] level of taxation’.⁴⁶

As to the justification, the UK government argued that the legislation on CFCs was intended to counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax jurisdiction by means of the establishment of a subsidiary in the latter and the setting up of transactions intended primarily to make such a transfer to that subsidiary. To begin with, the Court of Justice recalled that the need to protect tax revenue is neither one of the grounds listed in Article 52(1) TFEU nor a reason of overriding general interest that might justify a restriction on the freedom of establishment.⁴⁷ Similarly, it recalled that one cannot generally presume that a company is evading taxes merely because that company decides to exercise its freedom of establishment by setting up a subsidiary in another Member State.⁴⁸ However, a restriction on the freedom of establishment may be justified ‘where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned’.⁴⁹ Stated simply, restrictions on free movement which seek to counter abusive practices may be justified.

In order to determine the artificial nature of an arrangement, the Court of Justice stated that it was necessary to examine the objective pursued by the freedom of

⁴³ Case C-196/04 *Cadbury Schweppes*, para. 31.

⁴⁴ *Ibid.*, para. 37 and 38.

⁴⁵ *Ibid.*, para. 45.

⁴⁶ *Ibid.*, para. 46.

⁴⁷ *Ibid.*, para. 49 (referring to Case C-136/00 *Danner*, EU:C:2002:558, para. 56; and Case C-422/01 *Skandia and Ramstedt*, EU:C:2003:380, para. 53).

⁴⁸ Case C-196/04 *Cadbury Schweppes*, para. 50 (referring to Case C-264/96 *ICI*, para. 26).

⁴⁹ *Ibid.*, para. 51.

establishment, which is to 'allow a national of a Member State to set up a secondary establishment in another Member State to carry on his activities there and thus assist economic and social interpenetration within the [EU] in the sphere of activities as self-employed persons'.⁵⁰ Since the freedom of establishment pursues integration in the host Member State, the Court of Justice ruled that that freedom 'presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there'.⁵¹ Accordingly, in the key passage of the judgment the Court of Justice stated that

(...) in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.⁵²

As to the case at hand, the Court of Justice examined whether the UK legislation on CFCs was capable of preventing wholly artificial arrangements and, if so, whether it went beyond what was necessary to attain that objective. 'By providing for the inclusion of the profits of a CFC subject to [a] very favourable tax regime in the tax base of the resident company', the Court of Justice wrote, 'the legislation on CFCs makes it possible to thwart practices which have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory'.⁵³ Regarding the necessity of that legislation, the Court of Justice held, quoting *Emsland-Stärke* and *Halifax*, that

[i]n order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by [EU] law, the objective pursued by [the] freedom of establishment [i.e., the pursuit of genuine economic activity in the host Member State], has not been achieved.⁵⁴

Accordingly, in situations where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality, the profits of such a CFC cannot be included in the tax base of the resident parent company without infringing the freedom of establishment. Those circumstances relate to objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.⁵⁵ If those factors show that the CFC

⁵⁰ Ibid., para. 53.

⁵¹ Ibid., para. 54.

⁵² Ibid., para. 55.

⁵³ Ibid., para. 59.

⁵⁴ Ibid., para. 64.

⁵⁵ Ibid., para. 67.

does not carry on a genuine economic activity in the host Member State, its creation is to be considered as a wholly artificial arrangement (for example a ‘letter box’ or ‘front’ subsidiary).⁵⁶ Procedurally, the Court of Justice held that the resident company ‘must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine’.⁵⁷ In the same way, with a view to obtaining the necessary information regarding a CFC’s true situation, the UK may have recourse to Directive 77/799.⁵⁸ Specifically in this case, the UK could have also relied on the double taxation convention (DTC) it had concluded with Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains of 2 June 1976. As to the ‘motive test’ set out in the UK legislation on CFCs, it was for the national court to determine whether the scope of application of that test was limited to preventing ‘wholly artificial arrangements’.

One may draw five direct implications from the ruling of the Court of Justice in *Cadbury Schweppes*. First, and foremost, the Court of Justice stressed the fact that the home Member State must be able to counter wholly artificial arrangements which undermine its tax jurisdiction in relation to the activities carried out on its territory. Otherwise, the balance between Member States in terms of allocation of the power to impose taxes would be jeopardized.⁵⁹ This shows that there is a close relationship between the objectives of combating tax evasion and of safeguarding a balanced allocation of the power to tax between Member States,⁶⁰ notably where the case at hand concerns the cross-border offsetting of losses.⁶¹ In that regard, the Court of Justice has held that, where the objective of safeguarding a balanced allocation of the power to tax between Member States justifies the national legislation at issue, the fact that such legislation ‘is not specifically designed to [combat tax evasion does not prevent it from being] regarded as proportionate to the objectives pursued, taken as a whole’.⁶² Conversely, where such a balanced allocation of the power to tax is not at stake, the national measures seeking to prevent tax evasion must be specifically designed to counter abusive practices, that is, their scope must be limited to prohibiting wholly artificial arrangements which do not reflect economic reality.

⁵⁶ Ibid., para. 68.

⁵⁷ Ibid., para. 70.

⁵⁸ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, [1977] OJ L 336/15. See also Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, [2011] OJ L 64/1.

⁵⁹ Case C-196/04 *Cadbury Schweppes*, para. 56 (referring to Case C-446/03 *Marks & Spencer*, para. 46).

⁶⁰ See, for example, Case C-318/10, *SIAT*, EU:C:2012:415, para. 48. See M. Schaper, ‘The Need to Prevent Abusive Practices and Fraud as a Composite Justification’, 23 *EC Tax Review* (2014), p. 220–229.

⁶¹ Case C-231/05 *Oy AA*, EU:C:2007:439; and Case C-311/08 *SGI*, EU:C:2010:26.

⁶² Case C-231/05 *Oy AA*, para. 63; and Case C-311/08 *SGI*, para. 66. See, in this regard, M. Schaper, 23 *EC Tax Review* (2014), p. 221 (who argues that ‘the need to prevent abusive practices and fraud can be construed as a composite of the need to safeguard the balanced allocation of taxing powers and the need to ensure effective fiscal supervision’).

In *Felixstowe*, for example, after holding that the need to safeguard a balanced allocation of the power to tax between Member States was not at issue in the main proceedings,⁶³ the Court of Justice held that the contested UK legislation did not seek to combat tax evasion either. The reason was that that legislation 'in no way pursue[d] a specific objective of combating purely artificial arrangements, but [was] designed to grant a tax advantage to companies that are members of groups generally, and in the context of consortia in particular'.⁶⁴

Second, the Court of Justice recalled that 'the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty'.⁶⁵ It follows that Member States cannot prevent *bona fide* tax mitigation.

Third, where the setting-up of a subsidiary in the host Member State does not reflect economic reality, the objective pursued by the freedom of establishment has not been achieved.⁶⁶ Hence, such establishment constitutes a wholly artificial arrangement which does not entitle taxpayers to obtain a more favourable tax treatment in the home Member State.

Fourth, the concept of abuse of law comprises both subjective and objective elements. Subjectively, the person or company concerned must have the intention of obtaining a tax advantage by creating wholly artificial arrangements.⁶⁷ Objectively, in order to determine the existence of a wholly artificial arrangement, one must look at objective factors ascertainable by third parties which prove that the subsidiary at issue does not carry out a genuine economic activity in the host Member State. For example, those

⁶³ Case C-80/12 *Felixstowe Dock and Railway Company and Others*, EU:C:2014:200, para. 30.

⁶⁴ *Ibid.*, para. 34. Arguably, a joint reading of *Oy AA*, *SGI* and *Felixstowe* clarifies how those two objectives are to interact with one another. Compare D. Weber, 'Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 2', 53 *European Taxation* (2013), p. 313–328, 321–322.

⁶⁵ Case C-196/04 *Cadbury Schweppes*, para. 50 (referring to Case C-264/96 *ICI*, para. 26; Case C-478/98 *Commission v. Belgium*, EU:C:2000:497, para. 45; Case C-436/00 *X and Y*, EU:C:2002:704, para. 62; and Case C-334/02 *Commission v. France*, EU:C:2004:129, para. 27). See also C-9/02 *Lasteyrie du Saillant*, para. 51; and Case C-371/10 *National Grid Indus*, EU:C:2011:785, para. 84.

⁶⁶ For a discussion on the concept of 'economic reality', see, e.g., D. Weber, 'Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 1', 53 *European Taxation* (2013), p. 251–264, 257.

⁶⁷ Some scholars have criticized the usefulness of the subjective element. See, e.g., M. Lang, in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*, p. 448. Compare D. Weber, 53 *European Taxation* (2013), p. 257 (who opines that the principle of legal certainty and the principle of legality would oppose denying a tax advantage to a taxpayer who has relied on the clear wording of the law and has no intention of obtaining such an advantage by means of wholly artificial arrangements. In those circumstances, the author posits that 'the fact that it can be established that a certain treatment is in conflict with the object and scope of a provision is not sufficient to come to the conclusion that abuse is present'. In his view, abuse is present, in so far as the taxpayer has the intention to abuse).

factors could examine whether the subsidiary physically exists in terms of premises, staff and equipment. Moreover, the Court of Justice pointed out that there is no abuse of the freedom of establishment where the subsidiary carries out a genuine economic activity, regardless of whether its establishment in a particular jurisdiction is motivated by the desire to mitigate tax liability.

Fifth, some scholars posit that the concept of abuse of law applied by the Court of Justice in *Cadbury Schweppes* is narrower than that applied by the Court of Justice in *Halifax*.⁶⁸ Indeed, whilst in the former case, the Court of Justice defined ‘abusive practices’ as ‘wholly artificial arrangements’, in the latter case it held that ‘the essential aim of the transactions concerned is to obtain a tax advantage’. Later, in *Part Service*,⁶⁹ another VAT case, the Court of Justice clarified that the expression ‘essential aim of the transaction’ is not to be interpreted as meaning ‘the sole aim pursued by the transaction’, but as denoting ‘the principal aim of the transaction or transactions in question’.⁷⁰ This means that, in the context of VAT, a national court may find that an arrangement constitutes abuse, ‘notwithstanding the possible existence, in addition, of economic objectives arising from, for example, marketing, organisation or guarantee considerations’.⁷¹

For Vanistendael, the fact that *Halifax* and *Part Service* concerned purely internal situations may explain why the concept of abuse applied by the Court of Justice in the context of VAT litigation is broader than that applied in direct taxation cases. In his view, in those two cases, the national court ‘was dealing with [a problem of] interpretation that was very much akin to the interpretation of a national tax rule’.⁷² The Court of Justice was therefore right to adopt a more flexible concept of abuse which grants national courts a margin of appreciation. Besides, he argues that ‘cross-border abuses had to do with VAT carousels, which could be easily classified as an abuse, because there is no redeeming Union virtue in these carousels, except for the naked desire for a tax advantage’.⁷³ However, situations involving a fundamental freedom are different. In *Cadbury Schweppes*, there was a clear EU interest in making sure that in order to prevent the reduction of tax revenues, national authorities did not ‘abuse’ the concept of ‘abuse of law’, by depriving individuals of the tax advantages accompanying a legitimate exercise

⁶⁸ R. De la Feria, 45 *CML Rev* (2008), p. 428. See also F. Vanistendael, ‘*Cadbury Schweppes* and Abuse from an EU Tax Law Perspective’, in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*, p. 422 (who argues that ‘[t]he difference is that under the [*Cadbury Schweppes*] ruling, any other reason than a tax advantage is sufficient to keep at bay the abuse concept, whilst under the [*Part Service*] holding there may be a mix of tax and non-tax reasons, but if the tax reasons are more important or even one of the important reasons, abuse is established’).

⁶⁹ Case C-425/06 *Part Service*, EU:C:2008:108.

⁷⁰ *Ibid.*, para. 45.

⁷¹ *Ibid.*, para. 62.

⁷² See, in this regard, Case C-285/09 *R*, EU:C:2010:742. See also F. Vanistendael, in R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*, p. 423.

⁷³ *Ibid.*

of the right to free movement. To that end, the Court of Justice decided to limit the concept of abuse to 'wholly artificial transactions'.⁷⁴

§4. THIN CAP AND GLAXO WELLCOME

A. THIN CAP: ANTI-AVOIDANCE RULES ON THIN CAPITALISATION

This case concerned the compatibility with the freedom of establishment of UK anti-avoidance rules which were targeted at 'thin capitalisation'. Thin capitalisation consists in financing a company by way of loan in preference to equity capital, in order to benefit from a more advantageous tax treatment.⁷⁵ Previously, in *Lankhorst-Hohorst*, the Court of Justice had examined the compatibility with EU law of German rules on thin capitalisation. However, the scope of those rules was too broad, as they applied generally to any situation in which the parent company had its seat, for whatever reason, in another Member State.⁷⁶ By contrast, in *Thin Cap*, the UK legislator had progressively adapted its legislation so as to avoid such over-inclusiveness. Accordingly, *Thin Cap* was the first case in which the Court of Justice was called upon to apply the concept of abuse set out in *Cadbury Schweppes*.

The UK legislation in force up until 1995 provided that interest paid by a resident company was, in principle, treated as a distribution to the extent that it represented more than a reasonable commercial return on the loan in question. However, where the loan was granted by a non-resident company to a resident company, the interest paid for that

⁷⁴ Commentators have also compared the ruling of the Court of Justice in *Cadbury Schweppes* with that in *Centros*. See, generally, R. de la Feria and S. Vogenauer (eds.), *Prohibition of Abuse of Law: A New General Principle of EU Law?*. See also V. Edwards and P. Farmer, 'The Concept of Abuse in the Freedom of Establishment of Companies: A Case of Double Standards?', in A. Arnall, P. Eeckhout and T. Tridimas (eds.), *Continuity and Change in EU Law Essays in Honour of Sir Francis Jacobs* (OUP, 2008), p. 205; L. Cerioni, 'The "Abuse of Rights" in EU Company Law and EU Tax Law: A Re-reading of the ECJ Case Law and the Quest for a Unitary Notion', 21 *European Business Law Review* (2010), p. 783–813; and A. Saydé, 33 *YEL* (2014), p. 162. For the purpose of this contribution, it suffices to say that the ruling of the Court of Justice in *Centros* is consistent with Article 54 TFEU, since that Treaty provision allows room for regulatory competition in the field of company law. Each Member State is free to choose between the 'registered office', the 'central administration' or the 'principal place of business' as the decisive criterion that determines the application of its company law. Notably, this means that a Member State may not refuse the registration of a branch of a company whose registered office is in another Member State simply because the latter Member State follows the incorporation doctrine. Similarly, *Cadbury Schweppes* may not be read as ruling out regulatory competition in the field of direct taxation. In the absence of EU harmonization in that field, it is for each Member State to determine the level of taxation it wishes to apply. Accordingly, a resident company may rely on its right to free movement in order to obtain a more favourable tax treatment in the host Member State, provided that the branch of such a company carries out a genuine economic activity in that Member State.

⁷⁵ In this regard, see Opinion of Advocate General Geelhoed in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, EU:C:2006:436, para. 3–5.

⁷⁶ Case C-324/00 *Lankhorst-Hohorst*, para. 37.

loan was treated as a distributed profit – and that, regardless of whether that interest represented a reasonable commercial return on that loan –, unless the UK had concluded a DTC to the contrary. In accordance with those conventions, the interest paid for that loan was deductible where the amount of interest did not exceed what would have been paid on an arm's length basis. Between 1995 and 2004, the UK legislator amended those rules in the following terms. Interest paid by one company to another belonging to the same group of companies was treated as a distribution to the extent to which that interest exceeded the amount that would have been paid at arm's length between the payer and the payee of the interest, or between those parties and a third party. However, those rules did not apply when both the borrowing company and the lending company were subject to tax in the United Kingdom.

At the outset, the Court of Justice noted that, since UK anti-avoidance rules only applied in relation to companies which controlled or exercised a definite influence over the borrowing company, the freedom of establishment applied to those rules.⁷⁷ Next, the Court of Justice found that there was a difference in treatment according to the place in which the lending company had its seat. Where the lending company had its seat in the UK, the borrowing company could deduct the interest it paid under the loan from its taxable profits. Conversely, where the lending company had its seat in a Member State other than the UK, such deduction was, in principle, excluded, thus increasing the liability of the borrowing company to tax. By putting a resident borrowing company receiving loans from a non-resident company in a less advantageous position than that of a resident borrowing company receiving loans from resident company, UK anti-avoidance rules constituted a restriction on the freedom of establishment. Indeed, those rules made it less attractive for companies established in a Member State other than the UK to acquire, create or maintain a subsidiary in the latter Member State.

As to the justification, the UK argued that its anti-avoidance rules sought to fight abusive practices.⁷⁸ In recalling its case law, the Court of Justice concurred with the UK in that Member States are entitled to adopt measures specifically targeted to 'wholly artificial arrangements designed to circumvent the legislation of the Member State concerned'.⁷⁹ However, it pointed out that '[t]he mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty'.⁸⁰

As a next step in its reasoning, the Court of Justice proceeded to examine whether UK anti-avoidance rules complied with the principle of proportionality. In this regard, it

⁷⁷ Case C-524/04 *Thin Cap*, para. 35.

⁷⁸ The UK government also argued that its anti-avoidance rules sought to preserve the coherence of its tax system. However, the Court of Justice found no link between the tax advantage concerned and the offsetting of that advantage by a particular tax. Case C-524/04 *Thin Cap*, para. 68 and 69.

⁷⁹ *Ibid.*, para. 79.

⁸⁰ *Ibid.*, para. 73.

found that those rules were capable of protecting the tax jurisdiction of the UK over the activities carried out on its territory. Indeed, they 'prevent[ed] practices the sole purpose of which [was] to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory'.⁸¹ As to the necessity of the rules in question, the Court of Justice began by recalling that in order for the restriction at issue to be justified, it had to have the specific purpose of preventing wholly artificial arrangements designed to circumvent that legislation.⁸² In that regard, it recognized that '[t]he fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm's length may constitute an objective element of abuse that can be independently verified'.⁸³

Procedurally, the Court of Justice ruled that the taxpayer concerned had to be given the opportunity – without being subject to undue administrative constraints – to provide evidence showing that the transactions in question had a commercial justification. In addition, where those transactions are considered to be 'wholly artificial', 'the re-characterisation of interest paid as a distribution is limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties or between those parties and a third party been one at arm's length'.⁸⁴ The question whether the successive sets of UK anti-avoidance rules went beyond what was necessary to combat abusive practices was a question for the national court to determine.

By contrast, in *ITELCAR*, the Court of Justice had enough information at its disposal to rule that the Portuguese legislation at issue in the main proceedings went beyond what was necessary in order to combat abusive practices.⁸⁵ That legislation provided that, where a resident company paid interest applied to the part of an overall debt categorized as excessive to a lending company established in a third country with which the borrowing company had special relations, that interest was not deductible as an expense for the purposes of determining taxable profit. Conversely, such interest was deductible where it was paid to a resident lending company with which the resident borrowing company had special relations. At the outset, the Court of Justice noted that the Portuguese legislation constituted a restriction on the free movement of capital given that it was liable to deter a resident company from entering into a credit agreement with a company established in a third country. In seeking to combat tax evasion by preventing the practice of 'thin capitalisation', the Court of Justice recognized that the Portuguese legislation pursued a legitimate objective.

Next, the Court of Justice went on to examine whether that legislation complied with the principle of proportionality. Where the lending company established in a third country had a shareholding in the resident borrowing company, the Court of Justice

⁸¹ Ibid., para. 77.

⁸² Ibid., para. 79.

⁸³ Ibid., para. 80.

⁸⁴ Ibid., para. 83.

⁸⁵ Case C-282/12 *ITELCAR and Fazenda Pública*, EU:C:2013:629.

found that the corrective tax measure complied with the principle of proportionality in so far as the non-deductible interest was confined to the part of the transaction which exceeded that which would have been agreed on an arm's length basis.⁸⁶ This was not however the case where the lending company established in a third country with which the resident borrowing company had special relations did not have a shareholding in that company. In the absence of such a shareholding, the overall debt owned by the resident borrowing company to the lending company was considered to be part of an arrangement designed to avoid the tax normally payable.⁸⁷ That assumption was, in the Court of Justice's view, disproportionate as it applied to conduct the economic reality of which could not be disputed.

B. *GLAXO WELLCOME*: LIMITING OFFSETTING REDUCTION IN SHARE VALUES

In *Glaxo Wellcome*, the legal framework was as follows: in order to avoid double economic taxation of the profits distributed by companies resident in Germany to resident taxpayers, German law gave those taxpayers the right to offset in full the corporation tax paid by the distributing companies against their own income tax or corporation tax liability. In addition to that tax credit, a resident taxpayer was entitled to deduct from his taxable profits the reduction in value of the shares he held in a resident company which resulted from the distribution of dividends. This was because from the point of view of the German legislature, the distribution of dividends did not generate income. Accordingly, if the taxpayer did not have any other income in the year in question, that tax credit was converted into a right to a refund. Moreover, the sale of shares above their nominal value constituted income for the purposes of German law and was liable to income or corporation tax. However, German law provided that a resident taxpayer was not entitled to deduct from his taxable profits the losses resulting from the partial reduction in value of the shares he held in a resident company where he had acquired his shares from a shareholder residing in another Member State (the 'contested legislation').

With regard to non-resident taxpayers, their income from the distribution of profits of resident companies and the profits arising from the sale of shares in such companies were not liable to income or corporation tax in Germany. Non-resident taxpayers were also unable to invoke the application of the imputation system in full in respect of the profits distributed to them by resident companies: therefore they could not obtain a tax credit equal to the tax paid by the resident distributing company.

Had the contested legislation not been adopted, the German government claimed that it would have been possible for non-resident taxpayers to obtain, without entitlement and in advance, the tax credit allowed only to resident taxpayers by having recourse to

⁸⁶ Ibid., para. 38–39.

⁸⁷ Ibid., para. 41.

the following practice: before the distribution of dividends took place, the non-resident taxpayer would sell his shares in a German company to a resident taxpayer at a price higher than its nominal value. In particular, that price would include the corporation tax paid by the resident company making the distribution. Accordingly, by obtaining the reimbursement of the amount of the tax already paid by that company, the non-resident taxpayer would make a capital gain which would not be liable to tax in Germany. For his part, the resident taxpayer would not only obtain the tax credit corresponding to the shares he had acquired, but would also be able to deduct from his taxable profits the reduction in value of those shares resulting from the distribution of dividends. If those shares were then sold back to the non-resident taxpayer, the same practice could then be repeated at the next distribution. To put an end to that practice, the German legislator decided to adopt the contested legislation which applied where a resident taxpayer had acquired his shares in a resident company from a non-resident shareholder at a price which, for whatever reason, exceeded their nominal value.

The facts of the case concerned the restructuring of the Glaxo Wellcome group which involved the acquisition of shares of GW-GmbH (a company established in Germany) by GV-GmbH (a resident taxpayer) from GG-Ltd (a shareholder residing in the UK). As a result of that acquisition, GV-GmbH became the sole parent company of GW-GmbH. Similarly, that restructuring also involved the acquisition of shares of W-GmbH (a company established in Germany) by GW-GmbH (a resident taxpayer) from GG-Ltd and W-Ltd (two shareholders residing in the UK). Since GW-GmbH was the sole shareholder of W-GmbH, the latter was merged into the former. In spite of that merger, the German tax authorities took the view that GV-GmbH was not entitled to deduct from its taxable profits the losses resulting from the reduction in the value of the shares that GW-GmbH held in W-GmbH, given that those shares had originally been purchased from shareholders residing in the UK. GW-GmbH challenged that decision on the ground that it was incompatible with EU law.

At the outset, the Court of Justice examined whether the free movement of capital or the freedom of establishment applied to the case at hand. It stated that 'the application of [the contested legislation did] not depend on the size of the holdings acquired from the non-resident shareholder and [was] not limited to situations in which the shareholder [could] exercise definite influence on the decisions of the company concerned and determine its activities'. Also, '[its] purpose [was] to prevent non-resident shareholders from obtaining an undue tax advantage directly through the sale of shares with the sole objective of obtaining that advantage'. As a result, the Court of Justice ruled that the legislation at issue in the main proceedings had to be examined in light of the Treaty provisions on the free movement of capital.⁸⁸ Next, the Court of Justice went on to determine whether the contested legislation constituted a restriction on the free movement of capital. In that regard, it observed that '[a] taxpayer's right to deduct from his taxable profits the losses

⁸⁸ Case C-182/08 *Glaxo Wellcome*, para. 49 and 50.

resulting from the partial reduction in value of the shares held in the company, where the reduction in value of the shares results from the distribution of the profits, undeniably constitutes a tax advantage'.⁸⁹ As the contested legislation limited the grant of such a tax advantage to a resident taxpayer who had acquired shares in a resident company from a resident shareholder, it made the acquisition of shares held by non-residents less attractive. In the same way, it dissuaded non-resident investors from acquiring shares in the resident company, representing an obstacle to that company's accumulation of capital from other Member States.⁹⁰ Thus, the Court of Justice ruled that the contested legislation constituted an obstacle to the free movement of capital.

Moreover, with regard to the losses resulting from a reduction in value of the shares held in a resident company, the Court of Justice found that 'those shareholders are in a comparable situation, whether the shares are acquired from a resident or acquired from a non-resident'.⁹¹ 'The distribution of profits', the Court of Justice wrote, 'reduces the value of a share, whether it was previously acquired from a resident or a non-resident, and in both cases that reduction in value is borne by the resident shareholder'.⁹² Accordingly, the contested legislation did not reflect an objective difference in the situations of those shareholders. This meant that in order for the contested legislation to be compatible with the free movement of capital, it had to be justified by an overriding reason in the public interest. In that regard, the German government argued that the contested legislation pursued three objectives recognized as legitimate by EU law: it sought to preserve the coherence of the German tax system,⁹³ to ensure the effective collection of revenue generated in German territory⁹⁴ and to prevent artificial arrangements whose purpose was to circumvent the scope of application of German legislation.⁹⁵

After rejecting the contention that the contested legislation was a proper means for ensuring the coherence of the German tax system,⁹⁶ the Court of Justice noted that it was 'capable of achieving the objective of maintaining a balanced allocation of the

⁸⁹ Ibid., para. 56.

⁹⁰ Ibid., para. 57.

⁹¹ Ibid., para. 58.

⁹² Ibid., para. 73.

⁹³ See, e.g., Case C-204/90 *Bachmann*, EU:C:1992:35, para. 28; Case C-319/02 *Manninen*, EU:C:2004:484, para. 42.

⁹⁴ See, notably, Case C-446/03 *Marks & Spencer*, para. 46.

⁹⁵ Case C-196/04 *Cadbury Schweppes*, para. 51 and 55; Case C-524/04 *Thin Cap*, para. 72 and 74; and Case C-330/07 *Jobra*, para. 3.

⁹⁶ For an argument based on such a justification to succeed, the Court of Justice requires that a direct link be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy, with the direct nature of that link to be examined in the light of the objective pursued by the rules in question. However, the Court of Justice found that such a direct link did not exist, as 'the disadvantages resulting from the legislation at issue in the main proceedings are suffered directly by the resident shareholder who has acquired those shares from a non-resident. For that resident shareholder, the impossibility of deducting from his taxable profits the losses resulting from the reduction in the value of the shares held in the resident company, where the reduction in value of the shares results from the distribution of the profits, is not offset by any tax advantage'. Case C-182/08 *Glaxo Wellcome*, para. 80.

power to impose taxes between the Member States and of preventing wholly artificial arrangements which do not reflect economic reality and whose only purpose is to obtain a tax advantage'.⁹⁷ Indeed, such legislation prevented practices with the sole objective of making it possible for a non-resident shareholder, who was neither a taxable person in Germany nor entitled to a tax credit for corporation tax paid by the resident company, to obtain such a tax credit. In doing so, it also ensured that profits liable to be taxed in Germany were not unduly transferred to the national tax base of another Member State. Moreover, notwithstanding the fact that it was for the referring court to determine whether the contested legislation went beyond what was necessary to attain those twin objectives, the Court of Justice provided the national court with some guidance in that respect.

The Court of Justice opposed general assumptions according to which 'any increase in the selling price necessarily takes into account the tax credit and is made solely for that reason', since it cannot be ruled out that

the shares were sold at more than their nominal value for reasons other than in order to obtain for the shareholder a tax credit for the corporation tax paid by the resident company or, in any case, that the undistributed profits and the possibility of obtaining a tax credit relating to those shares constitute only one element of their selling price.⁹⁸

When determining the existence of abusive practices, the Court of Justice held that the national court must embark on 'a case-by-case examination, taking into account the particular features of each case, based on objective elements, in order to assess the abusive or fraudulent conduct of the persons concerned'.⁹⁹ If the national court were to find that

[the contested legislation] cannot be limited to wholly artificial arrangements, established on the basis of objective elements, but covers all cases in which a resident taxpayer has acquired shares in a resident company from a non-resident shareholder at a price which, for whatever reason, exceeds the nominal value of those shares, the effects of such legislation [would exceed] what is necessary in order to attain the objective of preventing wholly artificial arrangements which do not reflect economic reality and whose only purpose is unduly to obtain a tax advantage.¹⁰⁰

⁹⁷ Ibid., para. 92.

⁹⁸ Ibid., para. 96.

⁹⁹ Ibid., para. 99. In the view of Advocate General Bot, the fact that shares are sold at a price higher than their nominal value may be an indication of abuse, but is not in itself conclusive evidence of abuse. He posited that one should also examine the speed with which and the price at which those shares are sold back to the non-resident shareholder. In addition, whilst the national legislator may establish a presumption of abuse, it must allow the operator concerned to rebut such a presumption by showing economic or financial reasons or very specific circumstances justifying such a transaction. See Opinion of Advocate General Bot in Case C-182/08 *Glaxo Wellcome*, EU:C:2009:438, para. 175 et seq.

¹⁰⁰ Case C-182/08 *Glaxo Wellcome*, para. 100.

§5. CONCLUDING REMARKS

Cadbury Schweppes, *Thin Cap* and *Glaxo Wellcome* provide national courts with useful guidance when they are called upon to determine whether a national measure prohibiting abusive practices complies with the fundamental freedoms. To that end, a national court must establish at the outset which of the fundamental freedoms applies. Next, it must examine whether the national measure at issue in the main proceedings constitutes a restriction on the relevant freedom. If that is indeed the case, it must look at the reasons that may justify such a restriction. It is thus at the justification stage that the national court must take into account the concept of ‘abuse of law’ developed by the Court of Justice in *Cadbury Schweppes*, *Thin Cap* and *Glaxo Wellcome*.

First, the fact that the company was established in a Member State for the purpose of benefiting from a more favourable tax treatment does not in itself suffice to constitute an abuse of the relevant fundamental freedom. It follows that tax mitigation which results from a legitimate exercise of the right to free movement is protected by EU law.

Second, EU law does not offer a shield to tax evaders, since Member States may prevent taxpayers from obtaining tax advantages resulting from ‘wholly artificial arrangements’ which do not involve the genuine exercise of an economic activity. Those arrangements constitute abusive practices. In order to determine whether an arrangement is wholly artificial, *Cadbury Schweppes* tells national courts to examine the intention of the taxpayer concerned and to look at objective factors which are ascertainable by third parties. To state the obvious, those objective factors are not always the same but may vary in accordance with the arrangement in question. For example, regarding the setting up of a subsidiary for the purpose of obtaining a more advantageous tax treatment, *Cadbury Schweppes* indicates that those objective factors may, for example, relate to the physical existence in terms of premises, staff and equipment of the subsidiary concerned (as opposed to a mere ‘letter-box’ subsidiary).

As to anti-avoidance rules on thin capitalisation, in the light of *Thin Cap*, national courts are advised to examine the interest paid by the resident company. The fact that that interest exceeds the amount that would have been paid at arm’s length between the payer and the payee of the interest, or between the companies of the same group and a third party, may imply the existence of abuse. Finally, regarding the offsetting reduction in share values, national courts must look at the price at which shares are sold by the non-resident shareholder. However, in light of *Glaxo Wellcome*, that determination is not in itself conclusive evidence of abuse. In addition, national courts may, for instance, enquire as to how much time elapsed between the sale of those shares and their resale to the original shareholder. Moreover, it appears that the Court of Justice gives more weight to the existence of objective factors than to the intentions of the taxpayer concerned. Indeed, in *Cadbury Schweppes*, the Court of Justice ruled that, regardless of the motivation behind the exercise of the rights to free movement, in the absence of objective factors proving the existence of a wholly artificial arrangement, there cannot be

an abuse. However, it would be very difficult for the taxpayer concerned to demonstrate that he did not intend to obtain a tax advantage where objective factors indicate the contrary.

Last but not least, regarding the principle of proportionality, the national measure at issue must be sufficiently finely calibrated so that it aims only at prohibiting abusive practices. This means that general and irrefutable presumptions establishing that certain transactions constitute abusive practices fail to comply with the principle of proportionality. Procedurally, Member States must allow the individual or company concerned to rebut such presumptions and, in any event, national courts must be able to assess the existence of abuse on a case-by-case basis.